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REAL ESTATE ASPECTS OF THE CURRENT TAX STRUCTURE

THE modern real estate appraiser and consultant must be aware of the aspects of our present tax structure which influence real estate investment decisions. This bulletin should not replace competent legal and tax advice, but it will enable the appraiser to realize that a certain tax situation exists and aid him in making proper recommendations in his report or survey.

Some of the areas in which real estate transactions are influenced by our current tax rules - depreciation, trades, and casualty losses - are dealt with in the following paragraphs. These rules explain why many real estate deals may be closed on the basis of very low capitalization rates, depending on the knowledge and application of tax laws and the tax brackets of the individual investor.

DEPRECIATION

Many real estate transactions are initiated to take advantage of the depreciation regulations of our present tax laws. In theory, the depreciation allowance is an attempt to allocate the cost of an asset to the accounting periods which are expected to gain from the use of the depreciated item. In recent years this purpose has been altered by the effects of inflation and efforts to encourage investment.

By applying one of the several allowed methods of depreciation, an investor can realize a deduction from his gross income that is in excess of the real depreciation in the building. This excess is returned to the investor (owner) in the form of a nontaxable return of capital. First and most familiar is the straight-line depreciation method, whereby a constant annual deduction is taken over the estimated life of the improvement. Another method is the 150% declining balance system. Under this procedure $1\frac{1}{2}$ times the straight-line deduction is allowed, but this percentage is applied to the decreasing value of the asset and not to its original cost. Thus, this method will result in a greater depreciation allowance in the early years of the asset's life. The 1954 tax code allowed a "first user" of a newly constructed improvement to apply a 200% or double declining balance system to the asset. This double declining balance method may be combined with the straight-line procedure during the life of the improvement. Therefore, when the early large depreciation deduction advantage falls to a point where it equals the straight-line deduction,

the owner can make a method change. Another procedure worthy of mention is the sum-of-the-years-digits method. An example of the computation of this method is as follows: If an asset had a life of 5 years, the years would be summed (5 + 4 + 3 + 2 + 1 = 15). The first year's depreciation would be 5/15 of the original cost, the second year's 4/15, and the third 3/15, etc.

The following schedule illustrates the aforementioned methods on an improvement costing $40,000 (exclusive of land) and having an estimated life of 10 years. The short life is merely for presentation of the schedules.

Year	Straight-Line Method	150% Declining Balance Method	Double Declining Balance Method	Combination Double Declining & Straight-Line	Sum-of-the-Years-Digits Method
1	$ 4,000	$ 6,000.00	$ 8,000.00	$ 8,000.00	$ 7,272.72
2	4,000	5,100.00	6,400.00	6,400.00	6,545.44
3	4,000	4,335.00	5,120.00	5,120.00	5,818.16
4	4,000	3,684.75	4,096.00	4,096.00	5,090.88
5	4,000	3,132.04	3,276.80	2,730.67	4,363.60
6	4,000	2,662.23	2,621.44	2,730.67	3,636.36
7	4,000	2,262.90	2,097.15	2,730.67	2,909.08
8	4,000	1,923.46	1,677.72	2,730.67	2,181.80
9	4,000	1,634.94	1,342.18	2,730.67	1,454.52
	$40,000	$32,125.02	$35,705.03	$40,000.00	$40,000.00

It is readily seen that an investor who desired the greatest early return on his investment would apply the fastest and earliest writeoff possible. This would be to his advantage, if he were to sell or trade his property after the depreciation advantage ran out. If the property were held over its entire life, the depreciation deduction would decrease, offsetting the early advantage obtained by using one of the accelerated methods. A real estate investment consultant should point out to a prospective investor or investment group that the inability to readily sell an improvement which was originally purchased with the intention of taking advantage of one of the depreciation methods would quickly offset the intended advantage. Current real estate syndication offerings advertise a return which is partly taxfree. Some of this taxfree return comes about from the distribution of funds derived from the use of one of the previously mentioned accelerated depreciation methods. This advantage is offset in the asset's later life unless the property increases in market value or is sold before the depreciation advantage is offset. When the property is sold, the long-term capital gains (which are part deferred profits) are taxed at 25% rather than the high tax rate usually experienced by the real estate speculator.

TRADES

The tax code states that "no gain or loss is recognized if property held for a productive use in trade or business or for investment is exchanged solely for property of a like kind to be held either for productive use in a trade or business or for investment." The term

"like kind" does not mean that a theater would have to be exchanged for another theater. It means that both properties involved in a trade must currently exhibit the productive or investment characteristics mentioned in the code's definition. For example, a taxpayer may exchange city real estate for a farm property. The code eliminates "dealer" property from the taxfree exchange provisions. "Dealer" property consists of property that is held mainly for resale and not for productive use. The productive use requirement would also exclude residential property unless it was used for income purposes. The tax on the profit derived from the sale of an owner-occupied home, however, can be avoided, if the seller acquires another home of equal or greater value than the selling price of his original residence.

In many cases the exchange of properties includes a cash payment on the part of one of the parties. If cash is used to equalize the values of the properties concerned, the taxfree provision is not forfeited. If the cash payment represents a profit, then that portion of the transaction would be subject to tax. For example, if a party wanted to exchange a building that was purchased for $50,000 for other real estate that has a fair market value of $55,000 plus $5,000 in cash, the gain from the exchange is $10,000, but only the $5,000 cash payment is recognized as taxable income.

While the receipt of cash may give rise to a taxable gain, the payment of cash by the other party does not allow a deductible loss to occur in the taxfree exchange transaction. For example, if one party exchanges a property worth $50,000 plus $20,000 cash for property worth $70,000, the first party may not take a deductible loss even though his property originally cost him more than $50,000. His deductible loss would be recognized for tax purposes when he later sells the property received in the exchange.

If exchanged properties are encumbered by mortgages, the code states that "the amount of any liabilities of the taxpayer assumed by the other party to the exchange . . . is to be treated as money received by the taxpayer." This can be demonstrated in the following way:

"A" transfers a property purchased for $250,000, which is also subject to a $75,000 mortgage, to "B," who gives "A" an improvement which has a fair market value of $350,000 plus a cash payment of $50,000. The transfer to "B" is made subject to the mortgage. "A" has a gain of $225,000 on the transaction, of which $125,000 is taxable. This is computed as follows:

Property obtained by "A" in trade	$350,000
Cash obtained by "A" in trade	50,000
Value of mortgage "A" transferred to "B" . .	75,000
Total amount "A" has realized	$475,000
Minus: Value of property "A" transferred . .	250,000
Gain "A" has realized	$225,000

As we have previously stated that only the cash gain is taxable and that mortgages are treated as the equivalent of cash, "A" has a taxable gain of $125,000 computed as follows:

Amount of "money" "A" received:	
Cash	$ 50,000
Value of mortgage "A" transferred to "B"	75,000
Recognized taxable cash gain	$125,000

CASUALTY LOSSES

Loss or damage to a property caused by a ". . . sudden, unexpected or unusual cause" is deemed a casualty loss by our current tax code. Often in instances where such a loss occurs, an appraiser is employed to assess the damage done to the real estate involved.

In the case of a casualty loss incurred by an owner-occupied residence, the allowed deduction is the difference between the value of the residence immediately prior to the loss and its value immediately after the loss. This difference may not exceed the cost of the residence and must be reduced by any insurance proceeds collected.

If a business property sustains a casualty loss, the loss for purposes of a tax deduction cannot exceed the depreciated value of the improvement regardless of its market value at the time of loss. Assume that a business property with a depreciated cost of $80,000 (exclusive of land), but with a market value of $100,000, sustains a casualty loss of $10,000. Although the property is now worth $90,000 because of the 10 percent loss, the 10 percent is applied to the $80,000, resulting in an allowable loss deduction of $8,000. Beginning with calendar years starting after January 17, 1960, the deductible loss is the actual loss of $10,000 in the above example. In either case the loss is reduced by the value of insurance proceeds and cannot exceed the depreciated value, $80,000. For calendar years beginning prior to January 16, 1960, either method may be used.

If insurance proceeds exceed the allowable loss figure, a taxable gain would result unless the proceeds are reinvested to repair and refurbish the property within one year.

These have been just some of the areas in which our current tax law affects real estate activities and decisions. Again, we stress the need for professional legal and accounting advice for the proper and complete interpretation of the preceding tax factors.

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